

New digital tax policies: What, when, where, how and by whom?

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New digital tax policies

What, when, where, how and by whom?



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As global business becomes ever-more digital, a growing number of policymakers and commentators argue that tax protocols developed almost 100 years ago are now struggling to keep pace. In response, some countries and supranational groups are exploring different digital taxation models for the future. The details of such models are a moving target at present, and the current lack of agreement on how to proceed threatens to leave behind it a confusing tax landscape made up of a patchwork of different tax policies.

The outcomes to this situation could be confusion about which types of business activity are subject to tax, distortion of business decisions, double taxation, tax disputes, and potentially unanticipated increased costs to the existing and future digital strategies of businesses.

In this article, we will look at the European Commission's (the Commission) digital tax proposals at summary level, before looking more closely at what is driving the debate, what potential outcomes we may see, by whom, when and under which processes.

The current debate is not about tax avoidance or the existence of stateless income. It is, rather, about the division of tax rights among countries who consider that their citizens contribute to the profits made by some digitally focused companies, even if they do so via unconventional means.

Digital discord: conflicting perspectives among supranational standard setters

While digital taxation is shaping up to be a defining tax issue for 2018, the Commission and the Organisation for Economic Co-operation and Development (the OECD), the two standard-setting bodies concurrently studying this issue, are on differing paths. Indeed, even within Europe there are conflicting views. Meanwhile, individual countries driven by both political and revenue considerations have started to move forward with unilateral tax measures.¹

At the heart of this debate is the belief by the Commission and by some (but definitely not all) countries that there is a mismatch between where profits are currently taxed and where and how certain digital activities create value. To be clear, notwithstanding the fact that taxing digitalized activity was first addressed within the OECD's BEPS project, the current debate is not about tax avoidance or the existence of stateless income. It is, rather, about the division of tax rights among countries who consider that their citizens contribute to the profits made by some digitally focused companies, even if they do so via unconventional means.

The Commission believes the value creation mismatch is the result of a combination of several factors. First, they say that businesses can today supply digital services where they are not physically established, which the Commission describes as "scale without mass." Second, they posit that digital business models tend to have a heavy reliance on intellectual property assets, and are therefore more mobile. And third (and perhaps the biggest challenge in the debate) the Commission believes that a higher level of value than currently assessed comes from users' participation in the digital activities that some platforms enable – commonly described as "user value creation".

To combat this perceived mismatch, the Commission in late March released two digital tax proposals² that, if enacted in their current state, could significantly increase tax costs and compliance burdens for many businesses around the world.

The first proposal is described as an "interim" 3% digital services tax (DST) on gross revenues (i.e., turnover) derived from activities in which users are deemed to play a major role in value creation.

Three issues at the heart of the digital debate



The taxpayer-reported 3% tax would apply to revenue from the following activities:

- A. The placing on a digital interface of advertising targeted at users of that interface;
- B. The making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users;
- C. The transmission of data collected about users and generated from users' activities on digital interfaces.

Companies with total annual worldwide revenues of €750 million or more and that have annual EU taxable revenues of €50 million or more would be subject to the tax.

Certain types of companies – such as digital advertisers and platforms designed to allow users to connect with one another and trade in goods and services – would be within the scope of the tax as currently proposed, while others, such as online marketplaces without user-to-user selling, would be outside the scope. But the tax status of many other types of companies is far less clear. For example, many companies may sell information about their consumers to other companies (such as market researchers), but only a portion of the data may be from "digital" sources as defined by the Commission. It's also unclear whether background data analytics and data transmission to and from the cloud by businesses offering Software-as-a-service (SaaS) are included in scope.

The Commission's second, longer-term proposal is far broader, with more than 50 different digital activities potentially subject to tax. A "significant digital presence" (SDP) concept would result in a new digital permanent establishment (PE) definition, intended to establish taxable nexus, along with revised profit allocation rules to determine how the taxes on digitally-derived profits are distributed among countries.

¹ French President Emanuel Macron proposed a new tax on internet companies in April, although without providing any detail. Other examples include Italy, which established a 3% web tax on digital transactions, effective January 1, 2019; Slovakia, which amended its income tax in January 2018 to add a tax on providers of services on digital platforms; Hungary, which proposed an internet tax in October 2017; and India, which introduced an equalization levy on online advertising revenue in 2016 and a revised permanent establishment concept in 2018.

² European Commission issues proposals for taxation of digitalized activity: EY Global Tax Alert, 21 March 2018. ey.com/gl/en/services/tax/international-tax/alert--european-commission-issues-proposals-for-taxation-of-digitalized-activity.

The United States has stated on record that it is opposed to tax policies and proposals that single out digital companies.

Under this proposal, a company would be considered to have a significant digital presence (and therefore a PE) if the entity meets any one of three criteria:

- It exceeds €7 million in annual revenues from digital services in an EU Member State
- It has more than 100,000 users who access its digital services in a Member State in a tax year
- It enters into more than 3,000 business contracts for digital services in a Member State in a tax year

If subject to tax, the company would pay the headline corporate income tax rate in an EU Member State.

As drafted, both proposals are scheduled to go into effect January 1, 2020, although in reality, the timing of both remains far less clear. And while the longer-term proposal mirrors ongoing discussions occurring at OECD level, it would dramatically change the way cross-border tax norms operate today. If enacted at the EU level, it would require tax treaties to be renegotiated between countries and a change to the OECD's Model Tax Convention. That scenario could result in two different tax systems – one for the EU, and another for the rest of the world.

The challenging concept of unanimity

To be implemented, both of the Commission's digital tax proposals would need to gain unanimous support among EU Member States. Individual countries' political and economic concerns may make this challenging, especially for the "interim" DST proposal, which some Member States fear may negatively affect some key industries and trade relationships.

There is a possibility that the "enhanced cooperation" measure of the EU – seldom used – could be exercised if nine or more Member States wish to take the proposal forward.³ If either scenario fails to play out, an alternative (and, we suggest, unwelcome) outcome is that a number of EU Member States could simply move forward, unilaterally, with their own digital tax measures.

OECD: we agree to disagree

The OECD originally initiated, and has thus far led, the digital tax debate in connection with its ongoing BEPS project. Just a few days before the Commission issued its proposals, the Paris-based OECD issued an interim report on the tax challenges of digitalization, concluding that there is no consensus on the merits of an interim tax such as the one proposed by the Commission.⁴

Indeed, the OECD report eschewed specific recommendations and stated that the 116-nation strong BEPS Inclusive Framework (the group of jurisdictions that have agreed to implement the BEPS minimum standards) instead chose to further analyze the issues and complexities involved in developing policies in this area.

The report affirmed the OECD's goal of producing a final report in 2020, and an update to G20 leaders in 2019. Some EU Member States, meanwhile, have also expressed their preference to wait for the OECD's long-term recommendations, further complicating the situation.

US stance

The United States has stated on record that it is opposed to tax policies and proposals that single out digital companies⁵, and Chip Harter, US Deputy Assistant Secretary (International Tax Affairs) to the Treasury has been reported as saying, for example, that "permanent establishment issues are no longer a factor in the digital tax debate because the largest MNEs have shifted or are in the process of shifting to structures that use local low-risk distributors to report income on locally filed tax returns, relying on transfer pricing principles to determine how much profit to report."

In fact, some of the resistance by EU Member States to the Commission's interim proposals may be based on concern about US retaliation at a time when trade tensions are particularly high.

Where do we go from here?

Timing issues and impacts

The Commission hopes that both tax proposals will be submitted to the Council (the decision-making body of the EU, made up of all heads of state of all EU Member States) for adoption with final national adoption occurring by 31 December 2019 for 1 January 2020 transposition into EU Member States' national laws.

But these dates are very tentative, and indeed, the SDP proposal in particular will require consensus agreement of a magnitude that is arguably similar or even greater than that of key ATAD measures themselves, given the potential redivision of taxing rights it represents.

Moreover, should consensus indeed be reached, the SDP will take significant time to execute as it will require changes to hundreds of double tax conventions.

³ This measure would not bind the remaining Member States.

⁴ *The OECD's interim report on tax challenges arising from digitalisation: An overview.* EY Global Tax Alert, 20 March 2018. ey.com/gl/en/services/tax/international-tax/alert--the-oecd-interim-report-on-tax-challenges-arising-from-digitalisation--an-overview.

⁵ Statement of US Treasury Secretary Steven Mnuchin, March 16, 2018. <https://home.treasury.gov/index.php/news/press-releases/sm0316>.

A host of converging factors (many of which are deeply political) mean that it is quite possible that many nations – both in and out of the EU – will move forward and adopt independent turnover taxes of some form in the short to medium term.

That scenario in turn drives one of the most commonly voiced criticisms of the DST – that the likely extended timeline for implementation of the SDP means that the “interim” DST may well have far longer duration than anticipated.

For either proposal to reach national enactment, much needs to occur during the coming four to six months. It is also worth bearing in mind that the EU legislative process is known for generating outcomes that can sometimes look somewhat different from what was originally envisaged.

The situation is not this clear cut; a host of converging factors (many of which are deeply political) mean that it is quite possible that many nations – both in and out of the EU – will move forward and adopt independent turnover taxes of some form in the short to medium term.

Recent media reports, meanwhile, have stated that some countries (including Germany) may have cooled on the Commission’s 3% DST proposal in particular, fearing that it may indeed be an inhibitor to domestic activities or that it may prompt retaliatory measures.

So, while the wheels have by no means “come off” the Commission’s proposals, the go-forward picture presents an increased risk of unilateral actions on digital – which, of course, will mean more double taxation and more disputes.

A closer look at the drivers of the debate

Answering the question of “what happens next?” also requires a far closer look at some of the key issues behind the debate, as well as a study of how those issues link to political motivations.

As noted, this debate is not about tax avoidance. Equally, nor is it about taxing the end consumer of digital goods or services; that has largely been addressed via the application of VAT or GST in many jurisdictions. Rather, it is about taxing net profits and the division of taxing rights among countries.

Many countries agree on what is driving the perceived need for change – i.e., the potential mismatch resulting from the interplay of the concepts of scale without mass, increased reliance on intellectual property and the contributions made by digital users and the value of the data they create. What is less clear is how, when and by whom these issues will ultimately be tackled in terms of new tax policies.

This is a very political exercise at its heart, both domestically and internationally, and the digital tax issue is but one related strand in a multifaceted web of issues:

The EU’s legislative process

The EU’s legislative process will also contribute to the complexity of developments. The European Commission is but one player in a novel and unique legislative approach that each proposal issued by the Commission must transit.

The European Commission has the sole right to introduce new tax proposals; once a proposal has been introduced, it is effectively sent to the appropriate tax working group(s), which is where the detailed work is performed, with participants from all Member States meeting regularly to discuss the details of the proposal and to try and reach a consensus position. In these discussions, the working groups are free to make whatever amendments they want to what the Commission has proposed.

So, effectively, a proposal can be disassembled and then reassembled by the working group(s). The Commission can, but very rarely does, take a position that the working groups have distorted their original proposal so much that it is unrecognizable from its original form, and withdraw the proposal. Normally, however, what occurs is that the discussion carries on, as there is no time limit to the discussion – as has been the case with 2011’s CCCTB proposal.

Once the working groups have developed a proposal into a form acceptable to all Member States, the Council adopts it, according to a timeline set by the Commission – typically (but not always) allowing for a year or more of lead time for domestic legislation to be prepared. The European Parliament (made up of 750 elected members) must be asked for an opinion on the final proposal, but such opinion is not binding upon the Commission.

There is, however, an “escape clause” from unanimity, though it is very rarely used and has only been tried once on the tax side and twice on a wider scope.

Importantly, the treaties governing the running of the European Union require unanimity in tax matters for both indirect and direct taxation. There is, however, an “escape clause” from unanimity, though it is very rarely used and has only been tried once on the tax side and twice on a wider scope.⁶

Known as “enhanced cooperation,” the procedure may only be invoked if the Council (made up of representatives from the 28 Member States, the legislative decision-makers in all cases) fails to agree on a final proposal and proceedings comes to a halt, but more than nine Member States still want to move forward. The Commission can withdraw the current proposal and come forward with a new proposal, under enhanced cooperation, under which the final laws will apply only to those Member States that participated in enhanced cooperation and therefore agree to be bound by them.

The current digital tax proposals: three potential outcomes

Given the contours of the political landscape, coupled with the novelty of the EU’s legislative process, it is possible that one of the following scenarios will play out:

- First, EU Member States may be loath to use their power of veto and all may eventually accept the idea of the DST during the coming four to six months.
- Second, a group of Member States agree to move forward to implement a turnover tax under the enhanced cooperation mechanism.
- Third, countries simply create their own taxes, creating a web of unilateral regimes among a wide group of EU Member States, as well as other countries around the world.

Overall, it is also worth noting that the sense of confusion and lack of consensus in regard to the Commission’s proposals is arguably driving a return of the world’s focus to how the OECD will address the issue.

Do recent unilateral actions indicate any particular sense of direction?

In short, yes. Not unexpectedly, we already see a number of related developments playing out, and not limited solely to the EU bloc. For example:

- On 30 April 2018, Spain proposed the introduction of a Digital Services Tax, to be effective in 2018 and beyond. Even though no draft of the proposed new tax has yet been disclosed, it will presumably be aligned with the EU’s DST proposal. If the EU measure is developed as anticipated, the scope of Spain’s new law is expected to be the same as that of the EU’s 3% DST. The Spanish tax is likely to be introduced unilaterally.

- Likewise, Austria is expected to publish forecasted revenues from the proposed 3% DST on gross revenues on digital transactions, analyzed by category, according to the three areas of business activity identified by the Commission. Austria is also believed to be drafting domestic legislation around both the DST and the SDT, allowing adoption domestically should the EU proposals not move forward. An open question remains as to what rate Austria may apply; it may follow the 3% rate put forward by the Commission, but equally could look toward a 4% or even 5% rate, on the basis that a precedent-setting tax is already in place in Austria.
- Australia’s 2018 budget was held on 8 May 2018. The treasurer stated in his speech that the “*next big challenge is to ensure big multinational digital and tech companies pay their fair share of tax.*” He further stated that he has been working with the G20 to bring the digital economy into the global tax net and that in a few weeks he will release a discussion paper that will explore options for taxing digital business in Australia. This all comes not long after the Australian Financial Review reported the treasurer as stating that he would not wait for other countries to go it alone, and that “*The absence and delay in arriving at a multilateral solution will only continue to invite unilateral action by individual jurisdictions. As a consequence future multilateral action will likely be more focused on harmonizing approaches already commenced, than establishment.*”⁷
- Two months earlier, on 13 March 2018, the UK Government noted that the participation and engagement of users is an important aspect of value creation for certain digital business models, and is likely to be reflected through several channels, such as the provision of content or as a contribution to certain intangibles such as brand. The preferred and most sustainable solution to this challenge, says the UK’s policy paper, is reform of the international corporate tax framework to reflect the value of user participation. In the absence of international reform, the paper notes there is a need to consider interim measures, such as revenue-based taxes. The Government thinks there are benefits to implementing an interim measure on a multilateral basis and intends to work closely with the EU and international partners on this issue. However it notes that the UK is willing to act unilaterally.

⁶ In the areas of patents and divorce law.

⁷ *Australia to unveil proposals for multinational digital tax: Treasurer* – Australian Financial Review, 8 May 2018: [reuters.com/article/us-australia-dig-tax/australia-to-unveil-proposals-for-multinational-digital-tax-treasurer-idUSKBN11912G](https://www.reuters.com/article/us-australia-dig-tax/australia-to-unveil-proposals-for-multinational-digital-tax-treasurer-idUSKBN11912G).

The likelihood is that new taxes on digital activity of some form will soon need to be factored into businesses' strategic plans.

- Finally, the OECD is expected to publish statistics on digital penetration in OECD countries and to make available simulations of various instruments that may tax either profits or turnover – i.e., virtual PEs, withholding taxes, and excises/levies.

What to watch for next

The Commission's proposals have now been moved to the Working Party on Tax Questions (WPTQ), and monitoring of developments should therefore occur at two levels. Ongoing discussions with EU Member States' treasury and finance department officials will be valuable points of engagement at the present time.

More broadly, the Bulgarian Presidency issued a digital taxation roadmap document on 23 May 2018. In this roadmap, the Presidency outlined its desire for the WPTQ to complete a first round of detailed technical analysis on the DST by June 2018, allowing the Presidency to then table a first DST compromise proposal.

On the SDP, the roadmap notes that the same technical analysis is expected to be completed by June 2018, and the WPTQ meetings of 4 and 5 June 2018 will be dedicated to SDP discussions. The roadmap makes no mention of a similar compromise proposal on the SDP, however, instead noting that " *...work on this legislative proposal will have to be calibrated with a view to monitoring and reflecting, as appropriate, progress made in the G20/OECD debate, which is expected to be concluded by 2020.* "

Concluding thoughts

Many factors, including politics and economic interest, are shaping the current digital tax debate. While many details are still evolving, the likelihood is that new taxes on digital activity of some form will soon need to be factored into businesses' strategic plans.

Given the complexity of the issues outlined in this article, companies should begin studying existing and planned digital activity with a new lens, and to bring tax into the wider business strategy conversation. Putting in place or increasing efforts to assess, quantify, plan for and comply with changes at both multilateral and national levels will be a pre-requisite, moving forward.

Thought Center webcast: new digital tax policies

Stream the archive of our 29 March 2018 webcast and join our panellists as they discuss:

- ▶ The drivers for change and justifications for action being put forward by policymakers
- ▶ The short- and long-term proposals of the European Commission for a gross revenues tax, a digital permanent establishment definition and new profit attribution rules
- ▶ The views and recommendations of the OECD in relation to potential regimes to tax digitalized business activity



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⁶ ECOFIN is an Economic and Financial Affairs Council configuration – made up of the economics and finance ministers from all member states. Relevant European Commissioners also participate in meetings.

Scaling the digital tax divide

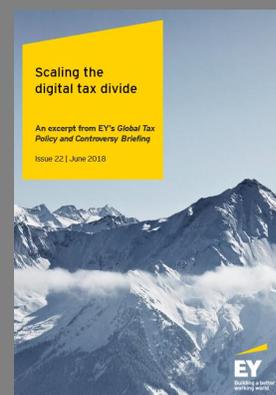
What boards and executive leadership need to know about the proposed digital tax policies

Given the complexity of the issues outlined in this article, company boards should begin viewing their existing digital activity and pipeline projects with a new lens, and to bring tax into the conversation.

Digital tax issues may also need to be incorporated into investor communications. Investors need to know about tax issues related to digital activities that may reduce profits if these taxes go into effect. They also should be informed about the possibility and potential impact of restructuring parts of a digital strategy or even the need to exit lines of business or markets completely depending on how tax proposals advance.



Scaling the digital tax divide is a short, new EY article designed with the C-suite, board and audit committee audience in mind. It is designed to help educate these audiences on why this digital debate is occurring, setting out the high level contours of the debate and the related proposals, and offering executive leadership a number of questions to ask themselves. *Scaling the digital tax divide* may be downloaded at ey.com/techbriefing.



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